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SUBJECT: EURO FINANCE WEEK PARTICIPANTS CALL FOR STRONGER U.S.
FINANCIAL REGULATION

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¶1. Summary: During the 12th Euro Finance Week 2009 in Frankfurt, top representatives of the European and international financial community agreed that the financial crisis is not yet over. The key lessons from the crisis include: that banks are essential to the real economy but need better internal risk management, and that stricter and more effective regulation at all levels is required. Participants felt frustrated with what they perceive as insufficient U.S. regulatory reforms and are skeptical about the US following through on regulatory promises made. They praised EU reforms, particularly the creation of a common rule book, but wonder about their effective implementation. Some questioned the ability of banks, many of which are still fragile, to support an economic upturn. End Summary.

The Crisis Is Not Yet Over: Looming Risks

¶2. While the economic free fall has been stopped and recovery is on its way, the economic situation is still fragile, stated both the President of the European Central Bank (ECB) Jean-Claude Trichet and Eurogroup President Jean-Claude Juncker. For Frank-Juergen Weise, Chairman of the Board of the German Federal Labor Agency, the core issue is not the intensity of the crisis, but its length. Chief Economist of Nomura Research Institute, Tokyo, Richard Koo warned of the risk of exiting too soon from the expansive fiscal policies after what he termed a "balance-sheet recession."

¶3. Banking sector leaders discussed problems that could still occur. "The worst in all business sectors is not yet behind us," said Bundesbank President Weber, warning of further upheavals from credit card and loan defaults, the high level of market liquidity, and remaining toxic assets. Board member of the metal workers' union (IG Metall) Hans-Jurgen Urban also speculated that if growth remains flat and a credit crunch occurs, many of the leaders in the German automobile, electronic, and machine building industries will not survive. Overall, Germany has learned that it needs to reduce its export dependence by making the country more attractive to foreign investors, said Wolfgang Franz, Chairman of the German Council of Economic Experts.

¶4. The Central and Eastern European (CEE) region also remains vulnerable, since it has the highest rate of non-performing loans in the world, noted Timothy Krause, IFC, Moscow. CEE countries will see a sharp contraction of net foreign capital inflows due to the crisis and competition from new emerging markets. These countries have realized, as per Hungarian Finance Minister Peter Oszko and Bank of Moscow President, Andrei Borodin, that "sustainable long-term growth cannot be generated by debt" or external capital. Structural reforms, a new privatization push, and good governance

will become even more important than in the past.

First lesson: Banks are integral and need to manage Risk
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¶5. A key lesson from the crisis, most agreed, was that Banks are integral to the real economy, and must improve their internal risk management. Some, such as the Chairman of DZ Bank's Managing Board, Wolfgang Kirsch, and Hesse Minister President Roland Koch, speculated that banks that had forgotten their primary function prior to the crisis, which is to finance the real economy. As for risk management, it was the failure to keep up with the banks' "risk appetite" which created problems, according to Hans-Dieter Brenner, Management Board Chairman of Helaba Bank. Most speakers saw higher equity capital buffers and liquidity reserves as the principal components of an improved risk management system (although they uniformly spoke out against the introduction of a leverage ratio as a regulatory requirement.) Josef Ackerman of Deutsche Bank pointed out that this will also require a strengthening of the position of risk managers within a bank's hierarchy and the change of risk management culture. The German Bundesbank proposed being more lenient on equity capital requirements in exchange for strengthened risk managers.

Second Lesson: Restructure Regulatory Architecture

¶6. Another key lesson from the crisis is the need for tighter, globally harmonized regulation on all levels. Bundesbank board member Hans-Helmut Kotz called the Financial Stability Board (FSB) the "key innovation that came out of the crisis." Speakers praised G20 accomplishments, although expressed concern as to whether the decisions will be implemented if the crisis wanes. Sharon Bowles, Chair of the Economic and Monetary Affairs Committee of the European Parliament, warned that new regulation must be gradually introduced

and made subject to impact studies to reduce potentially unintended consequences. Josef Ackermann, of Deutsche Bank, proposed an "emergency fund for banks," an idea dismissed by ECB Governing Board Member Jurgen Stark, who warned against creating "new incentives for moral hazard." German Economic Minister Rainer Bruederle warned banks that they should not expect governments to bail them out again.

EU Regulation: will it be sufficient?

¶7. Jacques de Larosiere, Chairman of the High-Level Group on Financial Supervision, singled out the creation of a single EU rule book as the primary accomplishment of EU regulatory reform efforts, as it will overcome diverse and often contradictory national regulatory systems. The new European Systematic Risk Board (ESRB) will be an advisory agency rather than a supranational supervisory agency, which should allow the more effective national supervisors to continue to supervise. According to de Larosiere, the EU will enforce the rule book through a "comply or complain" basis, and sanction non-compliance with "naming and shaming." CEBS (the Committee of European Banking Supervisors) and the Basel Committee will undertake an impact study of the new architecture in early 2010, with the new regulatory system in place by the end of 2011. de Larosiere warned against the regulatory proposals being further weakened by the EU Parliament. Sharon Bowles of the EU Parliamentary Committee on Monetary Affairs further questioned whether the new regulatory architecture was a "sufficient vaccine to inoculate against another crisis." Apart from enforcement, a key challenge will be reaching a common interpretation of the new rules.

Criticism and Skepticism of U.S. Reforms

¶8. Numerous voices expressed frustration with current U.S. regulatory efforts. Jacques de Larosiere called U.S. effort "insufficient", since they "keep an institutional patchwork that is completely ineffective." For Thomas Dietz, professor at the Bundesbank University, the "cacophony of voices" with which the U.S.

speaks in international fora leaves a "pathetic, devastating image." Sharon Bowles lamented that the U.S. had not even thought about a national insurance regulator, while Arnaud Vossen, Secretary General of CEBS, complained that "the entire world except the United States applies Basel II standards." Christian Clausen from Nordea, Stockholm, continued, "A bank book prudently run by Basel II rules survived the crisis extremely well."

¶9. Interlocutors were also concerned about tensions in the transatlantic conversation on regulation. Eddy Wymeersch, Secretary General of CESR (Committee of the European Securities Regulators), regretted that this dialogue had become increasingly difficult. "There are now ill feelings and frictions on all issues," he said pointing specifically to debates on credit rating agencies, accounting practices, and derivatives. Gabriel Bernardino, Secretary General of CEIOPS (Committee of European Insurance and Occupational Pension Supervisors), went so far as to say that if the U.S. does not implement the G20 agreements as promised, the EU Member States will have to rethink their relationship with the U.S.

¶10. Comment: Participants at European Finance Week largely accepted the need for tighter financial regulation and supervision. Less frequently discussed, however, was the tension between tighter regulation and economic growth. Critique of U.S. regulatory practices recurred during the summit, with a strong sense of impatience for the US to present an equivalent regulatory playing field. End Comment